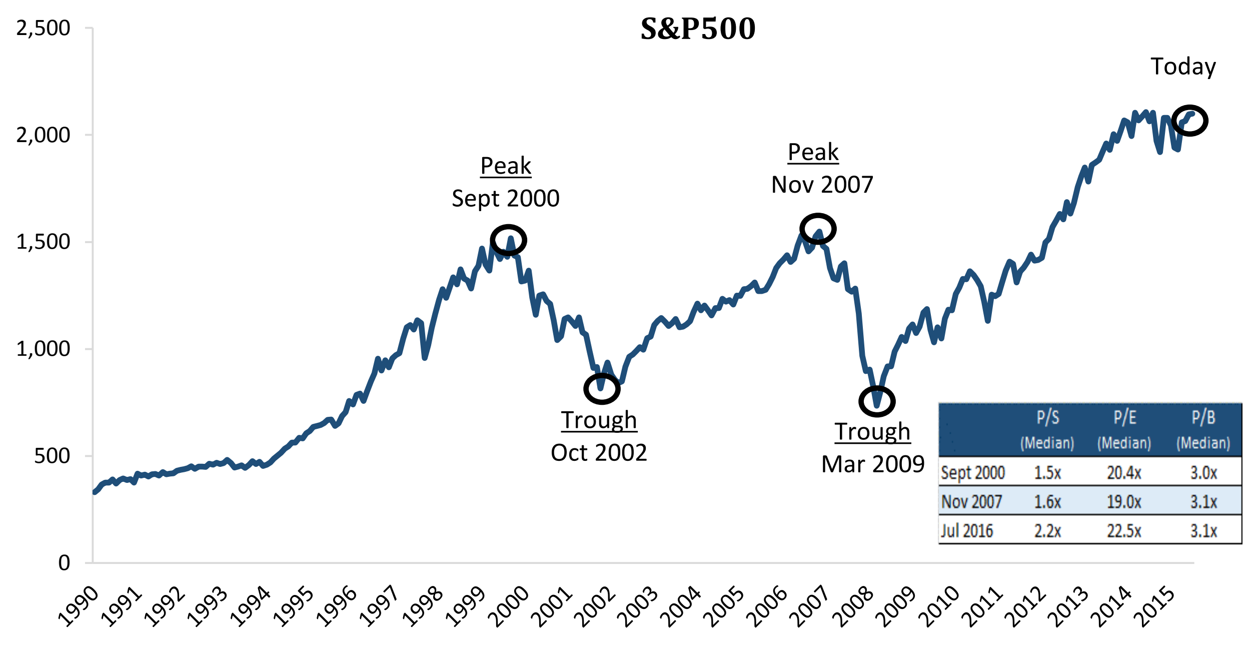
Large Cap Equity

Q2 2016 Commentary

Market Commentary

Making macro-economic prognostications is not a hobby we are fond of but we are fervent students of history as we believe there is much to be learned from the past. In Fig. 1 below we can see there have been some notable peaks and troughs over the years, and while there has been an enormous body of research documenting the comical inability of human beings to forecast inflection points, looking at the box in the lower right-hand corner, we do think it is notable that simple current levels of median market valuation are now at or above the levels seen at the market peaks in November of 2007 and September of 2000. While no one knows how high things can go we would suggest that in a world where people are literally receiving next to nothing, if not outright paying, to lend money to governments that have powerful political incentives to debauch the currencies these borrowings are being made in, it might be wise to have at least some of your savings invested in a low-cost, tax aware vehicle that emphasizes large and proven enterprises and seeks to exploit what history suggests is an inevitable and painful reconciliation of pompously priced promises with the cruel need to actually make money to fund operations. At the same time we watch with frustration while firms which have embraced capital discipline and operating excellence are shunned due to a lack of novelty. In the ensuing dialogue we are going to largely focus on what has gone wrong in the recent quarter and while we know that is atypical for a money manager, we believe it hews to our commitment to exhaustively study the outcomes of our process to ensure that we learn from mistakes when we make them and understand as well as can be understood our equity positions and their implications. With that said, since about late 2015 we have been increasingly frustrated with the market's seeming utter disregard for profitability and efficient capital deployment preferring instead to chase stocks that rise on what are often a combination of mediocre to sub-average fundamentals combined with fantastic promises in the distant future.

Fig. 1: The Market is Expensive Relative to History



	P/S (Median)	P/E (Median)	P/B (Median)
Sept 2000	1.5x	20.4x	3.0x
Nov 2007	1.6x	19.0x	3.1x
Jul 2016	2.2x	22.5x	3.1x

Source: Bloomberg; Data from 12/31/1989-6/30/2016 for index, Kailash Capital, Russell, Compustat for P/S, P/E and P/B data

Howard Marks once commented that "high quality assets can be risky and low quality assets can be safe. Its just a matter of the price paid for them."[1] This is one of those brilliant lines native to Mr. Marks that makes enormous sense, is easy to grasp but, quite frankly, can be agony to implement. In my 20+ years in the business I can never recall a time when such a sentiment has proven more-true than it is

[1] *The Most Important Thing, Uncommon Sense for the Thoughtful Investor,* Howard Marks

today. In Fig. 2 below, on the left under the heading "Fear and Loathing" is a large industrial manufacturer that we own with over a 110 year operating history that, as you can see from the top box, has experienced absolutely booming growth in profits over the last three years. Despite innovative new products, a newly aggressive approach to cost management, tremendous capacity rationalization in the industry, enormous free cash flows, nearly a 7% fully funded dividend, the rapid deleveraging of their balance sheet and nearly a 30% return on Equity, the stock trades as if it was on the brink of bankruptcy at only 5.5x trailing earnings and a price to sales ratio of 0.3%. We readily admit the firm is in a cyclical industry and has been prone to booms and busts, but with immense cash flows and a valuation that prices in a scenario only marginally better than that seen in the 2008 financial panic, we'd argue that the incredibly bearish future expectations of the firm are one of its greatest assets. As you can see, analysts expect future profitability declines in the mid to high teens next year and, despite these dour views, the stock still commands only 6x forward expected earnings. We believe that if we do indeed have a great financial recession as investors in this company seem to expect, we think there are a lot of other companies with far greater downside. Now let's switch over and examine the company on the right. This is a well-known consumer staples company, a manufacturer of consumer foods that showed up in a recent back-page article in the Wall Street Journal. In the article the CEO made several interesting comments on the causes of their recent economic decay and secular headwinds. As you can see, the company has had a difficult three years with sales, gross profits, EBIT margins and net income falling sharply and has unfortunately been relentlessly laying off employees.[2] But what struck me in the article was the CEO who defended his company's chronic declines in performance by stating that "Consumers are increasingly seeking products that match their personal definition of real food, and that can mean foods that are less processed and have labels with recognizable ingredients." When a food company's products are in secular decline because their ingredients lack "recognizable ingredients" I would suggest that might be cause for concern. Yet because they make "food" and is therefore perceived to be "safe" the stock commands a near 500% premium in PE multiple and nearly a 900% premium in price to sales over the firm on the left. Even more of a problem in our minds, the analysts have decided that despite the rocky past, this firm's future is nothing but sunshine and roses with net income expected to grow double digits next year in the face of further revenue declines. **We believe fiercely that these firms are near text-book examples of what Mr. Marks was alluding to.** A firm with huge tailwinds, booming profits and a shroud of pessimism trading as if it was about to go bankrupt (on the left) while a firm that is experiencing economic declines is priced as if it was a racy growth stock as it levitates on what we believe is an unearned investor fad around low volatility and perceived safety. We would argue that firm on the right is the dangerous one indeed. Despite ***the known facts***, the market has penalized the firm on the left causing it to underperform by over 31% while blindly embracing the "safe" story on the right, driving its price up nearly 25%.

Fig. 2: Profits pale in the face of perception

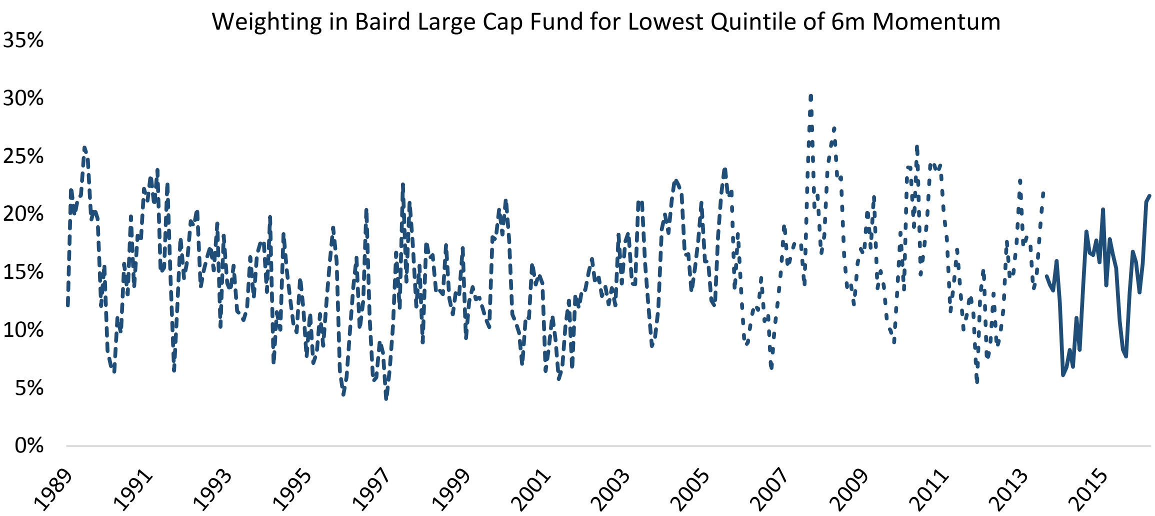
	Fear and Loathing		Loved	
Trailing & Est Growth	3Yr Trailing % Change	FY 2017E	3Yr Trailing % Change	FY 2017E
Sales	5.9%	-6.3%	-6.8%	-2.1%
Gross Profit	27.9%	-18.0%	-9.3%	2.1%
EBIT	74.9%	-21.4%	-5.1%	8.7%
Net Income	25.1%	-8.3%	-8.5%	10.3%
Firm Characteristics	Trailing 12m	FY 2017E	Trailing 12m	FY 2017E
Gross Profit Margin	15.5%	13.6%	35.2%	36.7%
EBIT Margin	6.2%	5.2%	16.3%	18.2%
Net Income Margin	5.8%	5.4%	10.2%	11.5%
Dividend Yield	6.8%	N.A.	2.5%	N.A.
Buyback Yield	0.4%	N.A.	0.8%	N.A.
P/E	5.5x	6.0x	24.9x	22.6x
P/S	0.3x	0.3x	2.6x	2.6x
P/B	1.6x	N.A.	7.3x	N.A.
ROE	28.8%	26.4%	27.6%	30.4%
	FY2013 - 07/28/2016		FY2013 - 07/28/2016	
Stock Performance Excess	**-31.5%**		**24.5%**	

Source: Bloomberg; Data from 12/31/2013-7/28/2016

[2] *The Wall Street Journal, Friday July 22nd 2016, p. B4*

So in the chart below I want to be very clear – our fund was designed using quantitative tools that were derived from what we believe are the most-sound components of fundamental investing. Our tenure on the fund began in December of 2013 – that's where the line is solid and the data is based on actual active positions. The dashed line preceding that point is hypothetical and based on hypothetical portfolio **weights**. With that said, the line in Fig. 3 represents the Baird Large Cap Fund's active weights in the 20% of firms with the worst six month trailing performance. You can see that at nearly a 22% weighting in the fund, we have an uncommonly high weight in companies that have been among the market's worst performers.

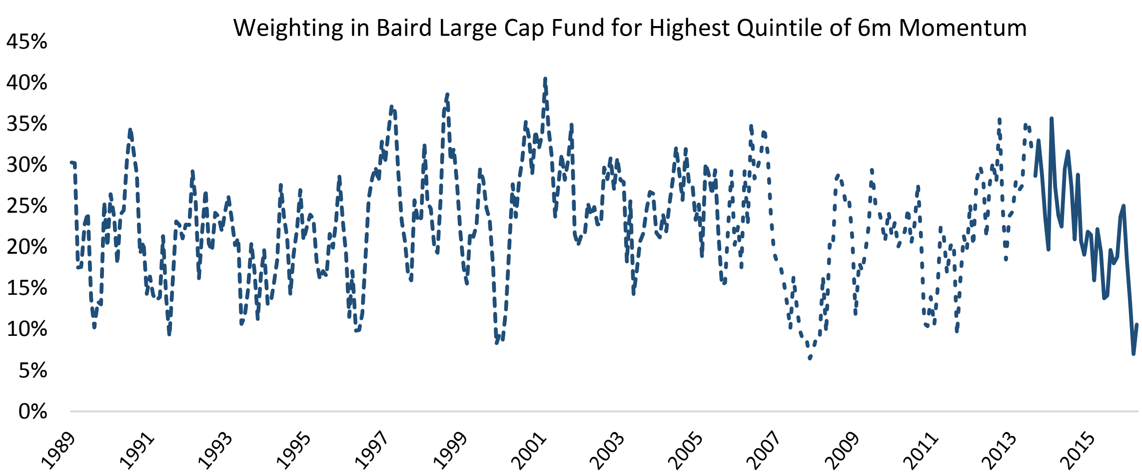
Fig. 3: We have an atypically high weighting in the market's worst performers



Source: Kailash Capital, Russell, Compustat; Data from 4/30/1989-6/30/2016, prior to 12/23/2013, all data is hypothetical portfolio weights represented by the dashed line vs. actual during in the period post 12/23/2013, represented by the solid line. Note: Data is ex-financials

Figure 4 below is just a mirror image of the prior one – it shows that the Baird Large Cap Fund has among the lowest weightings in HIGH momentum firms in real or hypothetical history**.** **To be blunt: we are underweight what has been on the run and overweight what has fallen the furthest.**

Fig. 4: We have an atypically low weighting in the market's best performers



Source: Kailash Capital, Russell, Compustat; Data from 4/30/1989-6/30/2016, prior to 12/23/2013, all data is hypothetical portfolio weights represented by the dashed line vs. actual during in the period post 12/23/2013, represented by the solid line. Note: Data is ex-financials

We have great respect for momentum as it is heavily endorsed by the academic community and also represents one of what we believe is the biggest unintended beneficiaries of index investing. Similar to the bubble in 2000 when the majority of truly great active investors with incredibly long and still valid track records of compounding investor wealth at very high risk adjusted rates fell on hard times, today is the heyday of index funds, index tracking ETFs and 20 year old money managers. If it is going up, buy it the thinking goes. Fundamentals, facts and economic moats be damned. One of the primary rationales for the success of the high momentum concept is that you are typically buying stocks with improving fundamentals and, as they rise due to these improving fundamentals, other investors take notice and jump on the bandwagon. The first three rows of Fig. 5 below provide the characteristics of high momentum stocks historically, as of the end of June and those in our portfolio respectively. Comparing the second row to the first, as a group, today's high momentum firms look AWFUL relative to their own history. You are paying a premium for firms with twice the debt and half the ROEs and substantially lower ROAs relative to their historic averages. To the extent we have positions in the high momentum cohort you can see that our firms trade at significant discount to the group despite having nearly 100% higher ROEs and balance sheets that carry half the group's current net-debt. Now let's contrast that with the bottom three rows which relate to the Low Momentum firms, or those companies with the weakest trailing 6 month returns. As a group, the low momentum cohort today looks unusually healthy with FCF yields that are 60% higher than historical averages despite elevated ROEs and lower than average levels of leverage relative to history. Looking at our positions within the group you can see that our firms are characterized by FCF yields that are nearly 2.5x the group average, trade at nearly a 50% discount on a PE basis and have double the ROEs despite roughly 30% lower leverage than the group.

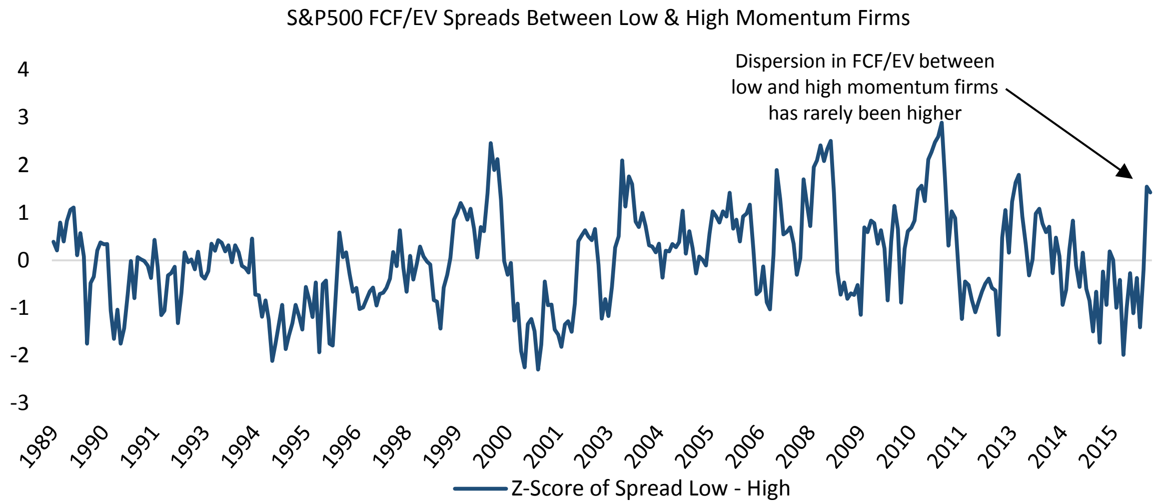
Fig. 5: We believe high momentum firms offer slim pickings while the low return cohort offers terrific opportunities

		FCF/EV	P/E	ROE	ROA	Net Debt/Price	6m Momentum
High Return	Historical Average	**3.1%**	**30.4x**	**18.1%**	7.9%	**16.2%**	43.4%
	Most Recent Month	**2.6%**	**31.9x**	**9.1%**	5.0%	**31.8%**	22.3%
	BHGIX Portfolio Today	**4.7%**	**23.1x**	**17.2%**	7.0%	**15.8%**	27.5%
Low Return	Historical Average	**3.2%**	**19.9x**	**18.3%**	7.5%	**28.0%**	-15.3%
	Most Recent Month	**5.1%**	**19.7x**	**25.3%**	8.3%	**22.4%**	-15.4%
	BHGIX Portfolio Today	**8.3%**	**10.2x**	**53.3%**	10.7%	**20.5%**	-18.3%

Source: Kailash Capital, Russell, Compustat; Data from 4/30/1989-6/30/2016
Note: Data is ex-financials

We do not relish being in the position of being underweight that which has been on the rise and overweight that which has been in decline but we think the pitch is incredibly fat. How fat? Figure 6 at the top of the next page simply scales the spread of FCF yields between the low momentum firms and high momentum firms and standardizes that spread using a Z-score. When the line is above zero it means low momentum firms are generating a lot more cash relative to their price than their high momentum peers and you can see that today, low momentum firms are priced roughly 1.5 standard deviations cheaper than their high momentum peers and has only had equivalent or greater advantages over their high momentum peers at the peak of the internet bubble, the period immediately following the '03 trough when the fed had cut rates from 6.5% to 1% inspiring a junk rally, the 2008 crash and finally the period following Draghi's "whatever it takes speech".

Fig. 6: Low momentum firms have an uncommon free-cash-flow advantage over their high momentum peers



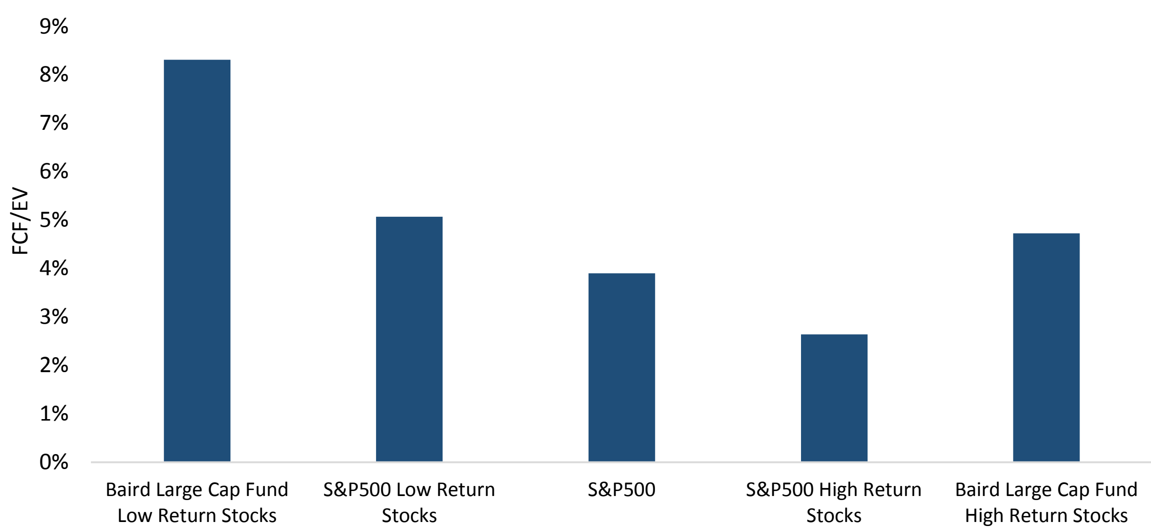
Source: Kailash Capital, Russell, Compustat; Data from 4/30/1989-6/30/2016
Note: Data is ex-financials

In case the preceding raft of tables and z-scores was not to your liking, Fig. 7 below shows very simply the free cash flow yields of (from left to right):

1. The low momentum firms in the fund
2. The 20% of firms in the S&P 500 with the lowest momentum
3. The S&P500 index as a whole
4. The 20% of firms in the S&P 500 with the highest momentum and…
5. The high momentum firms in our long book

We think the optics of the graph may prove prophetic as we believe there is much to smile about in the future performance of our long book.

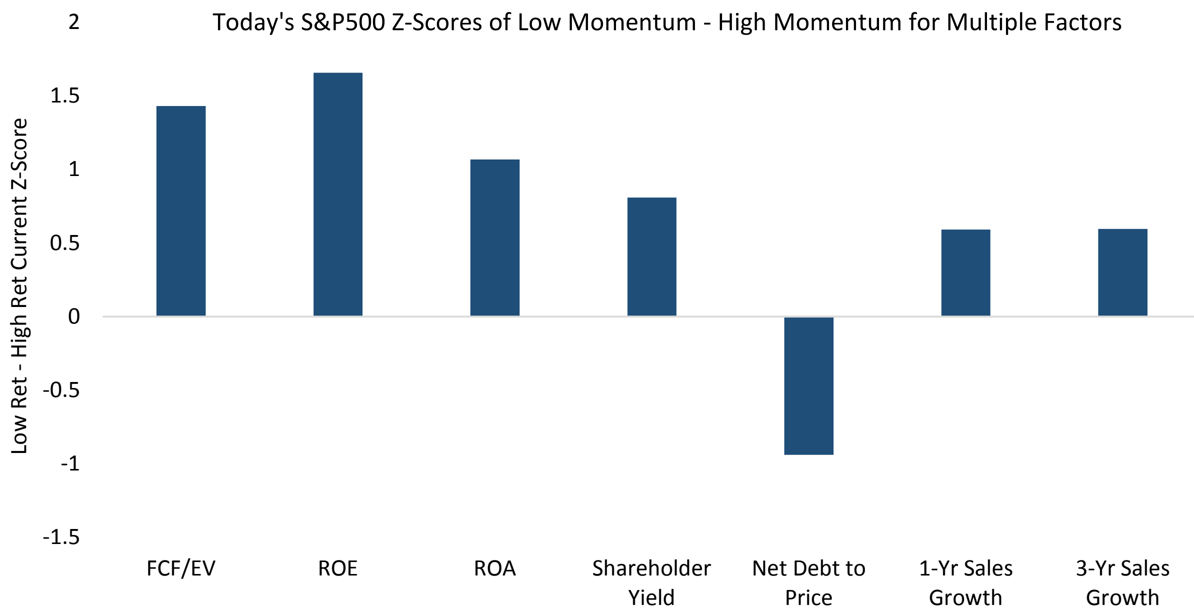
Fig. 7: Free cash flow characteristics of various groups



Source: Kailash Capital, Russell, Compustat; Data from 4/30/1989-6/30/2016
Note: Data is ex-financials

Just to quickly summarize the growing magnitude of the opportunity in front of us we put Fig. 8 below together. You can see that on virtually every fundamental metric, low momentum firms have atypically high levels of fundamental advantage over their high momentum peers. Just as a reminder – having a -1 sigma bar on Net Debt to Price means that these low momentum firms have unusually low levels of leverage relative to their high momentum peers and that despite this, they still command powerful advantages over high momentum firms on everything from FCF yields to ROEs to ROAs to Shareholder Yields to Revenue Growth rates.

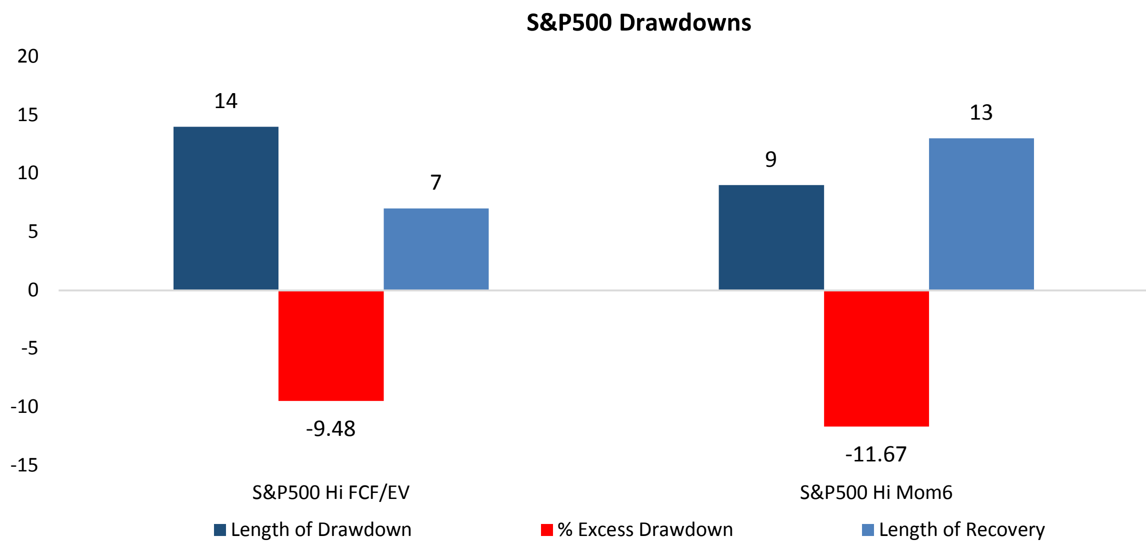
Fig. 8: Despite atypically low levels of net debt, low momentum firms have large advantages over their high momentum peers on numerous critical fundamental variables



Source: Kailash Capital, Russell, Compustat; Data from 4/30/1989-5/31/2016

In closing we think it is worth examining Fig. 9 at the top of the next page. In short, the fund is "overweight" firms with very high free cash flows as there is a dearth or rationally priced and healthy growth in our view. The left three bars examine the number of times the 20% of firms with the highest free cash flow yields have underperformed the market by 5% or more and how those situations played out. There are only 8 instances where this has happened so it is worth noting this is a robust sample, but using what we have, you can see that typically the relative drawdowns take 14 months, generate about 9.5% underperformance but then snap-back in just 7 months. On the right we did the same study for high momentum firms and here the incidences of sharp underperformance are much more common with over 30 incidences in the history file. We find it interesting that the outcomes here are almost a perfect mirror image of their high FCF peers. When momentum fails it is the investment equivalent of falling down an elevator shaft – the stocks typically trough out at ~12% relative underperformance in just 9 months and then it typically takes 13 months for these stocks to claw their way back to breakeven.

Fig. 9: Drawdown characteristics of high FCF yielding firms (left three bars) and high momentum firms (right three bars)



Source: Kailash Capital, Russell, Compustat; Data from 4/30/1989-5/31/2016

We make no claims to being able to time markets but with current levels equal to or above those seen at the market peaks of 2000 and 2007 we think time is running out, that accounting items like profits and prices paid will eventually matter again and that regardless of the market's direction some of our inexpensive firms have reached a point where the algebra simply becomes undeniable. When you have firms that trade at only a few times cash flow, even in a bull market that favors the fantastic and improbable, the cash flows of firms like ours become too big relative to price to be denied any longer.

We apologize for the lack of specific sector commentary. We believe market behavior and performance today has moved from the idiosyncratic to a function of a relentless investor preference for passive managers over active managers with the result being that price action begets price action independent of fundamental merit. Our hope is that the above demonstrates that this movement to the "mindless" has created one of the richest environments in history for those willing to do their homework. Should you want a detailed one-on-one to discuss some of the more specific sub-components of the value headwind we have faced and the potential opportunity we believe this is creating please contact Skip McGregor at smcgregor@rwbaird.com.

Sincerely,

L2 Asset Managmeent

The Baird Equity Asset Management Large Cap Equity commentary is incomplete if not accompanied with the most recent performance report.

Performance data quoted represents past performance. Past performance does not guarantee future results.

The S&P 500 index is an unmanaged, market capitalization weighted index of 500 common stocks widely regarded to be representative of the US market in general. The Russell 1000 Index is a stock market index that represents the highest-ranking 1,000 stocks in the Russell 3000 Index, which represents about 90% of the total market capitalization of that index. The Russell 2500 Index measures the performance of the 2,500 smallest companies in the Russell 3000 Index, or about 19% of its total capitalization. The Russell 3000 index measures the performance of 3,000 publicly held US companies based on total market capitalization, which represents approximately 98% of the investable US equity market. Indices are unmanaged and direct investment is not possible. Past performance is no guarantee of future results.

The strategy invests primarily in equity securities of large-capitalization companies. At times, large-cap stocks may underperform as compared to small- or mid-cap stocks, and vice versa. The strategy may also invest in ETFs which are subject to the same risks as their underlying securities, trade on an exchange throughout the day and redemptions may be limited.

Robert W. Baird & Co. 777 East Wisconsin Avenue, Milwaukee, Wisconsin 53202. 800-RW-BAIRD. rwbaird.com
First Use: 07/2016